II. The global economy

Highlights

The world economy grew strongly in 2005 but inflation remained subdued despite a further jump in oil and non-oil commodity prices. While the United States and China led the global expansion in early 2005, the recovery gained breadth in the course of the year, extending to Japan and continental Europe.

Global growth and inflation outcomes last year exceeded the optimistic forecasts of early 2005 despite headwinds from changes in the macroeconomic environment. First, inflationary pressures remained muted even as commodity prices rose further in the third consecutive year of buoyant world growth. Second, the US economy retained considerable strength despite the energy price hike and hurricane-related disruptions. Third, global financing conditions continued to be very supportive to growth, notwithstanding the progressive removal of monetary accommodation in the United States and, albeit less advanced, in the euro area. Finally, financial markets stayed calm despite the further massive and unexpected deterioration of the US current account balance during 2005. Although the US external deficit exceeded forecasts by about $100 billion in 2005, the dollar appreciated in real effective terms during the year.

Growth and inflation

Average annual changes, in per cent

	Real GDP				Consumer prices[1]			
	Average 1991–2003	2004	2005	2006[2]	Average 1991–2003	2004	2005	2006[2]
Total[3]	3.6	4.8	4.3	4.4	11.8	3.1	3.2	3.2
Advanced industrial economies[3]	2.3	3.0	2.6	2.8	2.2	2.0	2.3	2.3
United States	2.9	4.2	3.5	3.4	2.7	2.7	3.4	3.2
Euro area	2.0	1.8	1.4	2.1	2.4	2.1	2.2	2.1
Japan	1.1	2.3	2.6	3.0	0.5	–0.0	–0.3	0.4
United Kingdom	2.4	3.1	1.8	2.3	2.4	1.3	2.1	2.0
Other[3, 4]	2.6	3.1	2.6	3.0	2.2	1.6	2.0	2.1
Emerging economies[3]	5.4	7.3	6.9	6.7	25.9	4.9	4.5	4.4
Asia[3, 5]	7.2	7.9	8.0	7.7	6.1	3.8	3.3	3.7
Latin America[3, 6]	3.4	5.9	4.3	4.6	57.5	6.7	6.0	5.4
Central and eastern Europe[3, 7]	0.5	6.9	5.9	5.6	80.4	8.7	8.6	6.9
Other[3, 8]	2.3	4.8	5.4	5.0	5.5	1.0	2.3	2.9

[1] For the euro area and the United Kingdom, harmonised index; for Latin America, end-year data. [2] Consensus forecasts published in May. [3] Weighted average based on 2000 GDP and PPP exchange rates. [4] Australia, Canada, Denmark, New Zealand, Norway, Sweden and Switzerland. [5] China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand. [6] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [7] The Czech Republic, Hungary, Poland, Russia and Turkey. [8] Saudi Arabia and South Africa.

Sources: Eurostat; © Consensus Economics; national data. Table II.1

The consensus forecast for 2006 is for a continuation of firm growth and low inflation worldwide (Table II.1). Strong business confidence and low or declining unemployment support this optimism about the near-term outlook for growth. However, several features of the current global upswing are less positive: fiscal deficits are large; household saving seems unsustainably low in a number of advanced economies; corporate investment levels remain low; and global current account imbalances have reached unprecedented levels. At the same time, the inflation outlook has become more uncertain as oil prices have risen to new record highs and output gaps are narrowing or even closing in many countries.

Overview of the global economy

Continued buoyant growth and low inflation

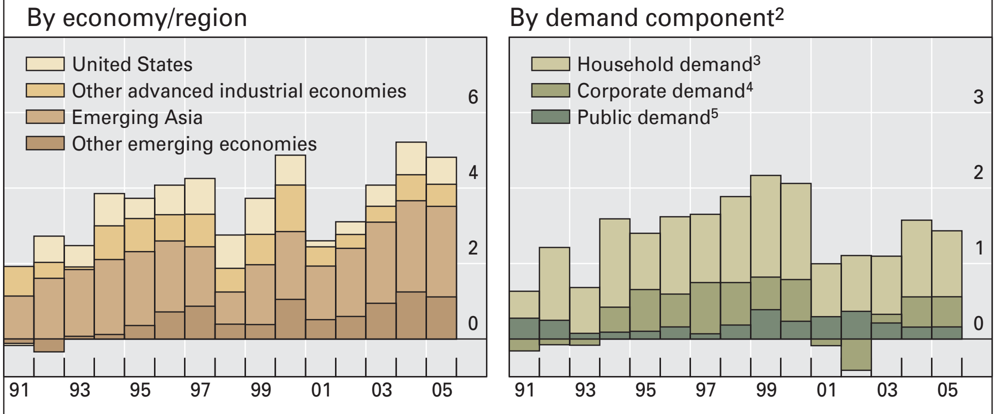
Third consecutive year of strong growth

World GDP growth in 2005 exceeded 4% for the third consecutive year, making this the strongest upswing since the early 1970s. While output in the Americas and Europe grew slightly less than in 2004, growth in Asia strengthened further. China's economic expansion continued unabated and the long-awaited revival of Japan added to the region's dynamism, not least because of the substantial complementarities of trade structures between Japan and emerging Asia. Overall, emerging Asia accounted for more than half of last year's increase in global output (Graph II.1).

Commodity prices continued to rise …

Rapid demand growth (especially in emerging Asia) supported a further rise in commodity prices in 2005, although capacity constraints in oil production and refining accentuated price pressures. Spot prices for crude oil hit $70 a barrel in late August 2005, an increase of about 60% from the beginning of the year. The steady increase in real oil prices over the past two years contrasts sharply with the supply-driven oil price shocks in the 1970s, when part of the

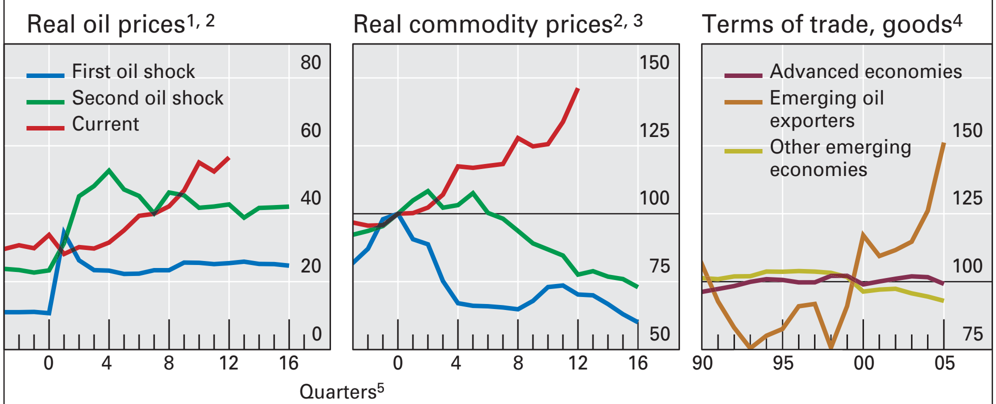
Contributions to world growth[1]



[1] In percentage points. [2] Advanced industrial economies. [3] Private final consumption expenditure plus private residential gross fixed capital formation. [4] Private non-residential gross fixed capital formation. [5] Government final consumption expenditure plus government gross fixed capital formation.

Sources: IMF; OECD; national data. Graph II.1

Oil and commodity prices and terms of trade



[1] Unweighted average of Dubai Fateh, UK Brent and West Texas Intermediate; in US dollars per barrel. [2] Deflated by world export prices; base year 1990. [3] World market; industrial raw materials, in US dollar terms. [4] 1990–2005 = 100. [5] Zero quarters correspond to 1973 Q4 (first oil shock), 1978 Q4 (second oil shock) and 2003 Q1 (current).

Sources: IMF; Bloomberg; Hamburg Institute of International Economics (HWWI); national data. Graph II.2

initial spike was reversed relatively quickly. The price of base metals and other commodities also rose in tandem with oil prices (Graph II.2).

... but global economic growth remained strong ...

The global economy proved remarkably resilient to the further sharp rise in energy prices. The net oil imports of OECD countries amounted to about 1½% of their GDP. This is ½ percentage point more than in 2004, but only about half of that in the 1970s. While the economic expansion in oil-importing countries remained intact, substantial terms-of-trade gains boosted growth in oil- and commodity-exporting emerging economies in Latin America, the Middle East and Africa.

... supported by subdued inflation ...

Stubbornly subdued inflation cushioned the impact of high energy prices on aggregate demand in oil-importing countries. Consumer price inflation rose only moderately from the levels observed in 2004. Second-round effects were largely absent, as wage moderation continued and corporate pricing power was limited. Longer-term inflation expectations remained firmly anchored. Against this backdrop, the central banks of the United States and, subsequently, the euro area and Japan pursued strategies of a gradual removal of monetary accommodation (see Chapter IV).

... and easy financing conditions

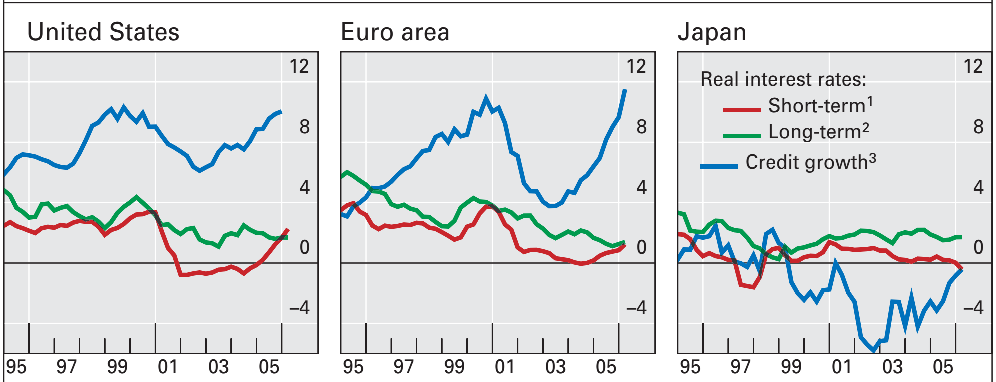
Persistently easy financing conditions worldwide provided another counterweight to the effect of rising energy prices on economic growth. Real short- and long-term interest rates in the major currency areas stayed well below long-term averages. Associated with this development, low risk premia supported asset values across the board: house prices boomed in many countries (see Chapter VII), and equity prices increased to multi-year highs virtually everywhere (see Chapter VI). Unusually tight credit spreads went hand in hand with an acceleration of credit growth, to rates comparable to those observed in the late 1990s.

Signs of a more balanced economic expansion

The expansion continued in the United States and China ...

The United States and China remained the main engines of global growth in early 2005. At the same time, buoyant US consumer spending and a

Financing conditions and credit growth



[1] Three-month rate deflated by 12-month changes in core consumer prices. [2] Ten-year government bond yields deflated by uncentred three-year moving averages of 12-month changes in headline consumer prices. [3] Credit to the private sector; changes from previous year, in per cent.

Source: National data. Graph II.3

continuation of very strong investment in China helped the euro area and the emerging Asian economies to overcome a weakening related to inventory adjustment in manufacturing. Indeed, exports picked up in Europe in the first half of 2005 and later in the rest of Asia, including in the previously lagging high-tech sectors.

... spreading to the euro area ...

The global expansion broadened as the year progressed. While the US economy retained considerable momentum and China continued to grow apace, strengthening domestic demand supported a recovery in continental Europe. Against the backdrop of buoyant profit growth, firming business sentiment and, more recently, rising capacity utilisation, the euro area recorded the strongest increase in business spending since 2000. Yet private consumption failed to recover. Growth differentials among the large euro area economies remained considerable, ranging from rapid economic expansion in Spain to below average growth in France and Germany, and stagnation in Italy.

... and firming in Japan

Rising domestic demand bolstered confidence that the recovery in Japan was firmly established. Vigorous business spending and the turnaround in credit growth suggested that the process of balance sheet adjustment in the corporate and financial sectors had finally run its course (Graph II.3). Private consumption rebounded on the back of improving labour market conditions. Domestic demand firmed in many emerging Asian economies (see Chapter III).

More balanced growth across components of demand

The economic expansion also became more balanced across components of aggregate demand. Corporate investment finally picked up in many advanced economies. In 2005, its contribution to domestic demand growth was comparable to earlier upswings in the United States and Japan but somewhat lower than in the second half of the 1990s in the euro area. Spending by private households – including residential investment – accounted for about 67% of total GDP growth in OECD countries, compared to more than 80% in the first half of the current decade. The recent decline is attributable to decelerating residential investment and a softening of private consumption following moderating housing market activity in Australia and the United Kingdom as well as hurricane-related disruptions in the United States.

Outlook and risks

Consensus forecast for continued strong growth in 2006 …

The consensus expectation for 2006 is for global growth to again exceed 4% and for moderate inflation to continue. Indeed, the economic environment appears favourable in many respects. Business sentiment has picked up globally, which bodes well for a further strengthening of corporate investment. Labour markets have firmed in the United States and Japan, and there are signs of improvement in the euro area. In Asia, a strong autonomous growth momentum seems to be gathering. Economic growth is also expected to accelerate in Latin America and remain strong in central and eastern Europe.

… is subject to event risk …

However, there are also downside risks. Leaving aside potentially catastrophic events such as an avian flu pandemic or a geopolitical crisis, several questions can be raised as to the sustainability of current macroeconomic trends over the medium term.

… and questions about the sustainability of current growth patterns

The configuration of key macroeconomic variables is highly unusual (Table II.2). First, oil prices have risen to new record highs and are, in real terms, about twice their long-term average. At some point, inflation pressures might grow, especially since output gaps are narrowing or even closing in many economies. Second, real long-term interest rates remain very low, notwithstanding the increase since the beginning of 2006. Neither the reasons behind historically low real interest rates nor the macroeconomic implications of a sharp increase after a long period of low rates are well understood. Third, while US corporations are net savers, measured household saving in the United States turned negative last year. Finally, external current account deficits have widened to unprecedented levels. The combined current account position of countries with an external deficit amounts to more than 2½% of world GDP, with much of this outcome accounted for by the United States.

2005: an unusual year

Annual averages or totals

	2005	Peak		Trough		Average 1980–2004
		Value	Date	Value	Date	
Global GDP growth	4.8	5.3	2004	1.2	1982	3.4
Real oil prices[1]	49.1	49.1	2005	14.0	1998	26.3
G3 real long-term interest rate[2]	1.6	5.3	1990	1.6	2005	3.5
US personal saving rate[3]	–0.4	11.2	1982	–0.4	2005	6.1
US corporate financial balance[4]	1.3	1.9	2003	–2.7	1980	–0.4
Current account balances[5]	–2.8	–1.1	1995	–2.8	2005	–1.6

[1] Unweighted average of Dubai Fateh, UK Brent and West Texas Intermediate; in US dollars per barrel. Deflated by world export prices; base year 1990. [2] Ten-year government bond yields deflated by uncentred three-year moving averages of 12-month changes in headline consumer prices. Weighted average based on 2000 GDP and PPP exchange rates. [3] As a percentage of personal disposable income. [4] Saving minus investment, as a percentage of GDP. [5] Sum of economies with a current account deficit, as a percentage of world GDP.

Sources: IMF; Bloomberg; national data. Table II.2

Inflation and wage setting behaviour in the global economy

Global inflation trends

Continuation of low and stable inflation

Global inflation remained low and stable in the period under review despite continued strong economic growth and rising energy prices (Graph II.4). Headline consumer price inflation in the United States rose to 4¾% last autumn as petrol prices peaked after the hurricanes, but fell back towards the end of the year. Headline CPI inflation in other advanced industrial countries also trended higher during the past year or so, but was still low by historical standards. Consumer price inflation moderated in Latin America and remained relatively stable in central and eastern Europe. Inflation trends in emerging Asia diverged: while inflation in China declined, despite continuing rapid economic growth, several other countries recorded rising inflation rates (see Chapter III).

Broadly unchanged core inflation

Core inflation rates stayed largely unchanged in the United States and Europe, resulting in a particularly wide gap between headline and core inflation in the third quarter of 2005. In Japan, inflation excluding fresh food crept up to ½% around the turn of the year. Core inflation in emerging market economies was broadly stable.

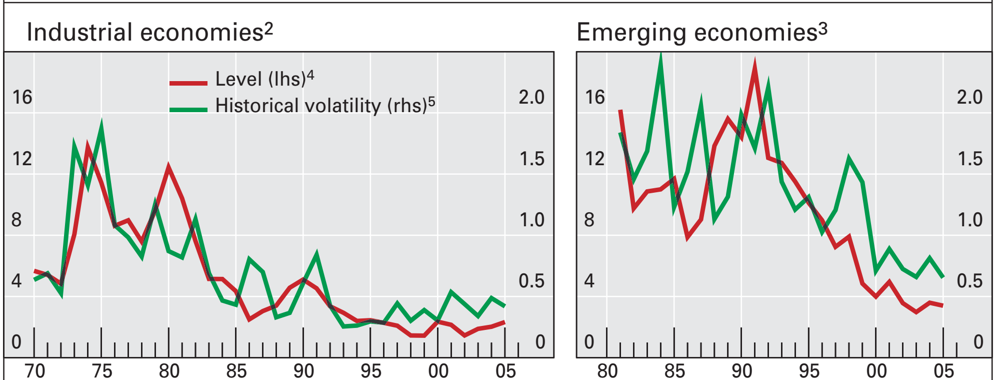
Lower inflation persistence …

That headline inflation failed to follow the upward movement of energy prices contrasts sharply with the wage-price spirals that characterised the 1970s. However, it is consistent with the more recent trend of declining inflation persistence. From 1970 to 1989 in the G7 countries, more than 80% of the price increases in the previous six months persisted into the following month. This ratio dropped to less than 50% in the United States after the 1990s, and fell likewise in Canada, Japan and the United Kingdom. The evidence is more mixed in the euro area. The degree of inflation persistence is also reported to have declined in many emerging economies.

… and low dispersion of inflation as global phenomena

Another global trend that has remained intact is the lower international dispersion of inflation rates worldwide. By 2005, inflation rates in advanced economies had converged to a range of about 0 to 3%, compared to a range

Global inflation[1]



[1] Annual changes in consumer prices. [2] Weighted averages based on 2000 GDP and PPP exchange rates. [3] Medians of the sample. [4] In per cent. [5] Standard deviation of monthly inflation rates within the year.

Sources: IMF; CEIC; national data; BIS calculations. Graph II.4

Contribution of a common factor to inflation in advanced economies[1]										
	Level of inflation rate					Volatility of inflation rate				
	Average 1970–89	Average 1990–2005	Difference[2]			Average 1970–89	Average 1990–2005	Difference[2]		
			Total	Explained by				Total	Explained by	
				Common factor[3]	Country-specific[3]				Common factor[3]	Country-specific[3]
United States	6.1	2.8	–3.3	–3.7	0.4	0.7	0.1	–0.6	–0.4	–0.2
Japan	5.6	0.6	–5.0	–5.3	0.3	2.2	0.2	–2.0	–0.3	–1.7
Germany	3.8	2.2	–1.6	–2.6	1.0	0.3	0.3	–0.0	–0.3	0.3
France	7.8	1.9	–5.9	–5.6	–0.3	0.9	0.1	–0.8	–0.6	–0.2
United Kingdom	9.5	2.6	–6.9	–6.9	0.0	2.4	0.3	–2.1	–0.5	–1.6
Italy	11.2	3.5	–7.7	–8.0	0.3	2.3	0.2	–2.1	–0.6	–1.5
Canada	6.7	2.2	–4.5	–4.5	–0.0	0.7	0.3	–0.4	–0.5	0.1
OECD	8.3	2.7	–5.6	–5.2	–0.4	1.7	0.4	–1.3	–0.4	–0.9

[1] Inflation rates of 22 OECD countries are decomposed to a common factor (ie co-movements across countries) and country-specific factors by a dynamic factor model. [2] Difference between 1970–89 and 1990–2005. [3] Contribution to difference.

Sources: OECD; BIS calculations. Table II.3

of about 20 percentage points in 1980. Coefficients of variation of inflation rates declined from 1.2 in the mid-1980s to less than 0.5 in 2005. Among emerging markets, successful macroeconomic stabilisation efforts have also reduced the dispersion of inflation rates since the mid-1990s.

Forces behind common inflation trends

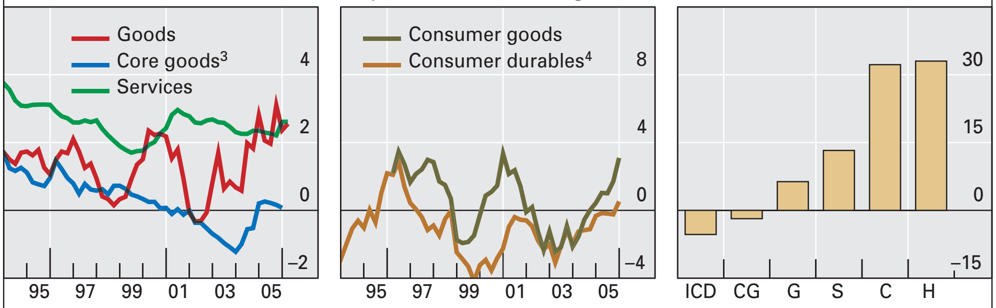
The forces behind these long-term trends in the inflation process are not entirely clear. The lion's share of the decline in the level and variability of inflation rates can be explained by a common factor (Table II.3). However, this measure arguably captures quite distinct economic causes. One element has been changes in the conduct of monetary policy. From this angle, common global inflation trends are the result of a simultaneous shift in domestic economic policies in many countries. Another, truly global, factor is the growing international integration of the markets for goods and factors of production, together with a shift in supply-demand conditions at the global level. In this regard, the economic opening of China, India and the former Soviet bloc, but also the growing economic strength of Asia and Latin America, have played a key role. The apparently greater significance of global measures of economic slack as drivers of domestic inflation is an indication of the increasingly global character of the inflation process (see Chapter IV).

Shifts in relative prices are consistent with globalisation affecting inflation …

Large movements in relative prices at the global level, over the past five years or so, lend support to the view that changes in the real economy have affected global inflation dynamics. On the one hand, commodity prices have risen by more than 30% (Graph II.5). This increase has coincided with booming demand for commodities, raw materials and energy from emerging economies: non-OECD countries accounted for about two thirds of the 20% growth in global oil demand from 1995 to 2005. On the other hand, the supply of manufactured goods has soared through exports from these newly integrated emerging economies. For instance, export volumes of developing Asian economies increased by about 15% per year in 2000–05. During this period,

Trends in relative prices[1]

Goods and services[2] | Imported consumer goods[2] | Between 2000 and 2005[5]



[1] Weighted averages of the United States, the euro area and Japan, based on 2000 GDP and PPP exchange rates; changes, in per cent. [2] Over four quarters. [3] Goods excluding food and energy. [4] United States and Japan. [5] ICD = imported consumer durables; CG = core goods; G = goods; S = services; C = commodities; H = houses.

Sources: HWWI; national data. Graph II.5

the prices of imported consumer durables fell by 5% in the major industrial countries while the prices of many non-tradable goods continued to rise.

These shifts in relative prices contrast starkly with the patterns observed during the oil price shock in the late 1970s. From 1978 to 1981, the prices of goods, services and commodities in the G3 increased more or less uniformly in the order of 25–35%.

… and contrast sharply with past experiences

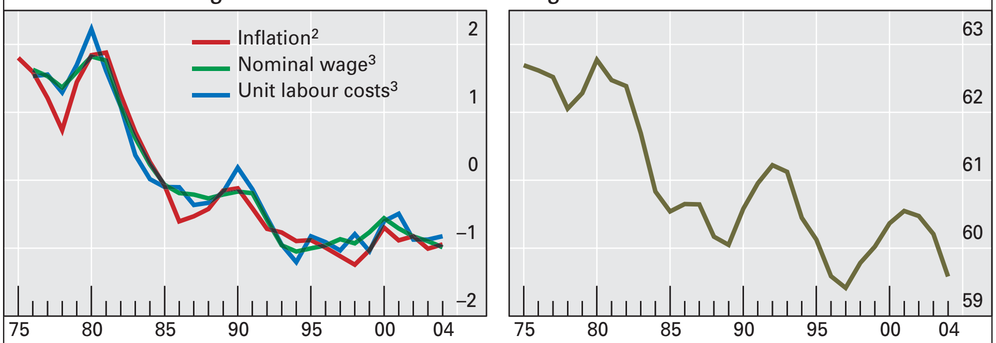
Wage setting behaviour and globalisation

The secular decline in inflation has gone hand in hand with great restraint in nominal wage growth. Increases in unit labour costs have moderated in tandem with nominal wages, and wage shares in the total economy have fallen by 5% over the past three decades or so (Graph II.6).

Secular restraint in nominal wage growth …

Inflation, wages and wage share

Inflation and wages[1] | Wage share[4]



[1] Common factors among OECD countries. Normalised data, measured as the difference between the indicator and its sample average, expressed in points of standard deviation. [2] Changes in consumer prices. [3] Business sector. [4] Total economy. Weighted average of the G10 countries, based on 2000 GDP and PPP exchange rates; as a percentage of value added.

Sources: OECD; national data; BIS calculations. Graph II.6

... resulting from several factors

Undoubtedly, several factors have played a role in this process. Many observers have argued that the greater credibility of monetary policy, achieved through a more active response to inflationary shocks, contained wage increases by providing a firmer anchor for inflation expectations (see Chapter IV). Moreover, higher labour productivity growth, thanks to capital deepening and technological progress, has also helped to limit increases in unit labour costs. Finally, coupled with lower union density and more decentralised collective bargaining, the deregulation of domestic labour markets over the past decade or so has tended to reduce the bargaining power of some groups of workers.

Globalisation has affected wage setting ...

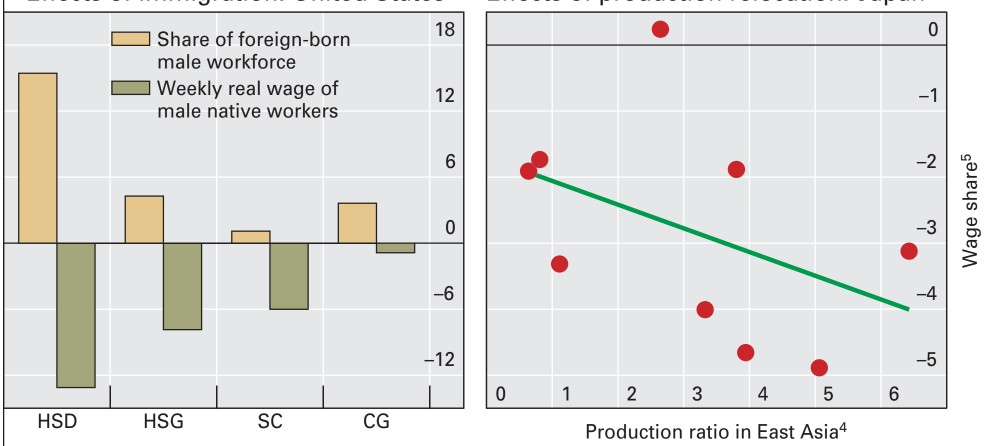
At the same time, the influence of the globalisation process should not be underestimated. The integration of emerging market economies into the global production process has, by some estimates, effectively doubled the supply of active workers engaged in the global economy. This, together with other aspects of globalisation, has arguably influenced labour market policies and wage setting behaviour in advanced industrial countries. At least three channels seem to have played a role in this process.

... through greater labour mobility ...

First, increased international labour mobility has helped to ease supply constraints in domestic labour markets. This seems to have mitigated upward pressures on wages, especially for low-skilled workers (Graph II.7). The awareness that a growing number of jobs are exposed to competition from immigrants could exert a significant influence on wages in countries where labour can easily move across borders. For instance, in the United States the influx of immigrants, which increased the supply of working males by 11% between 1980 and 2000, is estimated to have slowed wage growth by 3 percentage points. In western Europe, the average annual ratio of immigrants to population has essentially doubled since the fall of the Iron Curtain in 1989.

Globalisation and wages[1]

Effects of immigration: United States[2] | Effects of production relocation: Japan[3]

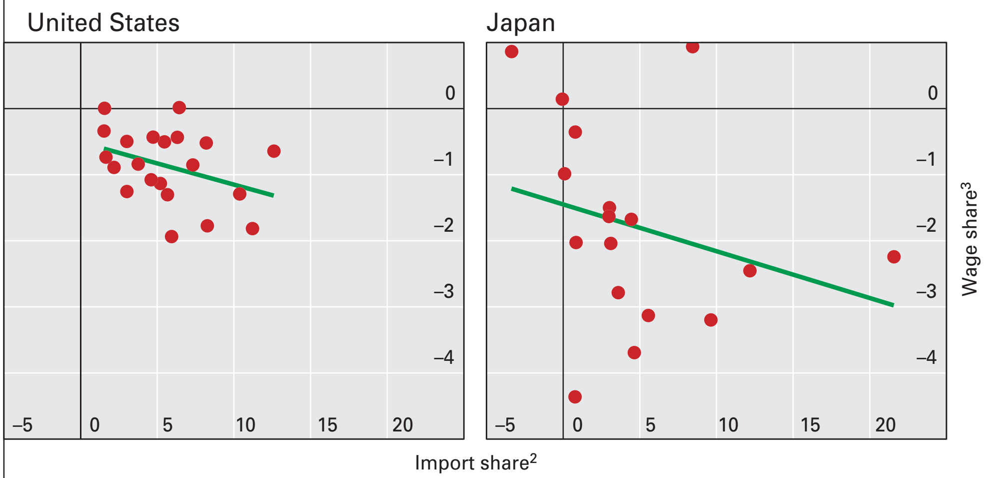


[1] Changes, in percentage points. [2] From 1990 to 2000. HSD = high school dropouts; HSG = high school graduates; SC = some college; CG = college graduates. [3] From 1994 to 2004. Based on nine manufacturing industries (excluding transportation). [4] Production in East Asia by Japanese manufacturers as a percentage of their total manufacturing production. [5] Wage payments as a percentage of sales.

Sources: G J Borjas, "The labor demand curve is downward sloping: reexamining the impact of immigration on the labor market", *Quarterly Journal of Economics*, vol 118, 2003, pp 1335–74; national data; BIS calculations.

Graph II.7

Import penetration and wages by industry sector[1]



[1] Changes, in percentage points, from 1998 to 2004. Based on 21 manufacturing industries for the United States and 17 for Japan. [2] Imports as a percentage of domestic consumption (output minus exports plus imports). [3] Wage payments as a percentage of sales.

Sources: National data; BIS calculations. Graph II.8

The effect of cross-border labour mobility on wages within Europe may have increased further after the EU enlargement in 2004. For instance, in the United Kingdom significant declines in workers' overtime payments were observed in 2005 in those industries in which non-UK nationals accounted for a large proportion of the workforce.

... the relocation of production ...

Second, the relocation of production – actual or threatened – has curtailed the bargaining power of workers and trade unions in many industrial countries. The rapid growth of trade in material inputs, such as parts and components, is an indication of the growing vertical integration of production processes at the global level. The growth rate of world trade in parts and components averaged 9% during the period 1990–2000, compared with 6½% for world trade growth as a whole. In the United States, the share of imported material inputs rose from 12% of total imports in 1992 to 17% in 2000. While the effect to date has mostly been felt in the manufacturing sector, higher-skilled and higher-wage jobs in the services sectors are becoming more and more contestable. The impact of relocating production facilities is visible in Japan, where industries that have actively pursued strategies of relocating production have tended to reduce wage shares more aggressively (Graph II.7, right-hand panel). In Germany, large firms have been able to negotiate real wage cuts in exchange for giving up plans to relocate production.

... and heightened competition

Finally, the opening of markets for goods and, increasingly, services to international competition has intensified competitive pressures on producers in advanced industrial countries. The greater contestability in goods markets has forced dominant domestic firms to step up their efforts to cut costs. The reduction of wage bills has been a key element in strategies aimed at curtailing the cost advantage enjoyed by producers in newly globalising countries such as China and India. Indeed, wage shares have on average fallen more in industries that have faced higher import penetration, such as apparel (Graph II.8).

Outlook

Consensus foresees continued low inflation

The consensus expectation is that inflation will remain low and stable in 2006, although the outlook has become more uncertain recently. Several indicators point to growing inflation risks from rising resource utilisation. Domestic output gaps are narrowing or even closing in many countries and capacity utilisation in manufacturing in the G3 is above long-term averages. Yet it is hard to gauge how much slack is actually left in the major advanced economies. For instance, the rate of unemployment that can be sustained without causing inflationary pressure may have declined as a result of changes in labour market participation or structural reforms. Perhaps even more importantly, globalisation might have lessened the responsiveness of wages to domestic output gaps, thus reducing the likelihood of inflationary pressures.

Low goods price inflation might persist …

Against this background, one key question is whether low inflation for traded goods will persist despite continued increases in raw material and energy prices. The acceleration in producer prices in the major advanced economies in the course of 2005 is a clear indication that pipeline pressures have intensified. Hence, much depends on whether (or when) firms regain pricing power at the consumer level and whether increases in wage costs will remain contained. Here, various indicators send different signals.

… as the relocation of production seems to continue …

Foreign direct investment in emerging market economies has remained strong, which may be a sign that the process of production relocation has not run its course. Import penetration has kept rising, which indicates continued downward pressures on domestic prices and wages. Nominal wage increases in the major industrial economies have so far remained well below historical norms and this, together with expected solid gains in labour productivity, should help to hold the growth of unit labour costs in check.

… but rising import prices raise questions

At the same time, the prices of imported consumer durables and core consumer goods prices seem to have stopped declining. Little is understood about wage and price formation and labour markets in the newly globalising emerging economies. Anecdotal evidence, such as double digit increases in labour costs in China for certain manufacturing workers in coastal areas, points to diminishing economic slack. Simultaneously, rising resource utilisation and persistently strong upward pressure on commodity prices may indicate that the output gap is narrowing even at the global level.

Private sector saving and investment

Trends

Oil-exporting countries and emerging Asian economies lifted global saving …

Global saving grew in 2005 to 22% of GDP. This is about 1½ percentage points higher than at the cyclical trough in 2002 and comparable to the average for the 1990s (Table II.4). Higher saving in the emerging economies continued to drive the recent increase. Oil-exporting emerging economies accounted for a growing share of global saving in 2005; their saving rates rose by 4 percentage points. Saving patterns in emerging Asia diverged. China's national saving rate grew further and is now at about 51%. Continued

Global saving and investment trends

As a percentage of GDP

	Average 1990–99	Average 2000–03	2004	2005	*Memo: 1991–2005*[1]
World saving	22.1	21.2	21.4	22.0	*–1.0*
Advanced economies[2]	21.7	20.1	19.4	19.4	*–3.2*
United States	16.3	15.5	13.4	13.3	*–2.9*
Euro area	21.2	20.9	21.2	20.9	*–1.0*
Japan	31.4	26.7	26.4	26.8	*–7.6*
Emerging economies[3]	23.7	25.4	28.6	30.3	*6.0*
Developing Asia	31.2	32.0	36.0	38.2	*9.7*
China	38.7	37.1	46.8	51.3	*13.5*
Latin America	18.3	18.5	21.3	21.8	*2.5*
Central and eastern Europe	21.1	18.8	18.5	18.8	*–8.0*
World investment	22.7	21.4	21.7	22.2	*–1.6*
Advanced economies[2]	22.0	20.7	20.5	20.9	*–2.5*
United States	18.7	19.2	19.6	20.0	*1.5*
Euro area	19.8	20.7	20.5	20.9	*0.7*
Japan	29.0	24.0	22.7	23.2	*–9.7*
Emerging economies[3]	25.5	24.3	26.4	26.4	*1.2*
Developing Asia	32.0	29.7	33.4	34.3	*4.0*
China	37.0	35.0	43.3	44.1	*9.4*
Latin America	21.0	20.1	20.6	20.7	*1.1*
Central and eastern Europe	23.8	23.1	24.3	24.0	*–3.6*

[1] Cumulative change, in percentage points. [2] Including Asian newly industrialised economies (NIEs). [3] Emerging economies other than Asian NIEs.

Sources: IMF; national data. Table II.4

strong profit growth of Chinese corporations suggests that the increase in 2005 might primarily reflect higher corporate saving. This would imply that household saving rates were largely unchanged at the very high level of about one quarter of GDP. In contrast, saving rates in the rest of emerging Asia declined. In central and eastern Europe and Latin America, they were broadly stable.

… while saving rates in advanced economies remained unchanged

National saving rates in the advanced industrial economies were unchanged, leaving rates well below the average for the past decade. But differences across countries were considerable. On the one hand, in Germany precautionary motives may have contributed to a further rise in the household saving rate. On the other hand, household saving rates fell markedly in the United States and Spain, where housing wealth rose sharply in 2005. At the same time, the corporate sector in the United States and other advanced economies remained a net saver. To the extent that higher corporate saving has increased the value of claims on the corporate sector in the past few years, lower household saving might be viewed as a response to rising corporate saving. Notwithstanding such effects, in the United States both the household saving rate, which turned negative by most measures in 2005, and the national saving rate appear unsustainably low.

Investment in China rose further

Investment rates picked up somewhat in 2005 in developed countries and were stable overall in emerging market economies. Again, patterns in emerging Asia diverged. In China, the national investment rate rose by another percentage point. Investment rates in other emerging Asian economies remained broadly unchanged, leaving gross fixed capital formation at much lower levels than before the Asian crisis.

Shift towards corporate investment in advanced economies

Investment activity in the advanced economies shifted from residential towards corporate fixed capital formation. Residential investment growth in OECD countries moderated to 3½%, compared to 6½% in 2004. Corporate capital spending remained firm in the United States and picked up in a number of other economies, including Japan and the Nordic countries, commodity exporters such as Australia and Canada, and parts of the euro area, including Belgium and Germany. By contrast, corporate investment remained relatively weak in the United Kingdom and declined in Italy.

Corporate profits and investment

Further rise in corporate profits

Corporate profits increased further in 2005 and appear to have reached historical highs as a percentage of global GDP. The forces behind the boom in corporate profits in recent years seem to be of a global nature, although sector-specific developments have also played their part. Operating margins have risen across non-financial sectors during the past few years (Table II.5). This increase lifted operating margins in many industries above the levels of the second half of the 1990s. Especially in commodity-related sectors, margins are now much higher. While pricing power in many sectors remained limited, a substantial and broad-based decline in labour costs supported higher operating margins. The fact that profits have risen even more during the current upswing is to an

Profit indicators for selected global industry sectors[1]

As a percentage of revenues

	Operating surplus[2]			After-tax profit		
	2004–05	Change[3]		2004–05	Change[3]	
		2001–02	1995–99		2001–02	1995–99
Airlines	3	3	–3	2	3	–1
Automobiles	4	0	0	2	1	0
Chemicals	9	3	1	6	3	1
Computer hardware	5	2	0	4	4	0
Industrial machinery	8	2	2	5	3	2
Mining	22	4	9	17	6	9
Oil and gas producers	14	3	5	9	3	4
Retail	5	1	1	3	1	1
Software	26	2	0	18	5	3
Telecommunications	16	3	–2	9	13	–1
Utilities	14	3	1	7	3	1

[1] Revenue-weighted average of firms included in the World Equity Market Index. [2] Revenues minus total operating expenses. [3] Average 2004–05 minus average 2001–02 and 1995–99, respectively.

Sources: Datastream; BIS calculations. Table II.5

important degree attributable to much lower interest expenses, another global development.

Record profits, high cash levels and low interest rates have not prompted record corporate investment. Corporate fixed capital formation recovered in 2005 and, in real terms, grew in advanced economies broadly in line with previous cycles. But the relatively weak investment in the early phase of the current upswing seems to have led to a cumulative shortfall in capital formation. Indeed, corporate investment as a share of GDP remained low in the G3 economies by past standards (Graph II.9). The fact that, in most of the sectors shown in Table II.5, fixed assets accounted for a significantly smaller share of all corporate assets in 2004–05 than in the second half of the 1990s confirms the notion of relative investment weakness.

Investment levels remained below historical norms

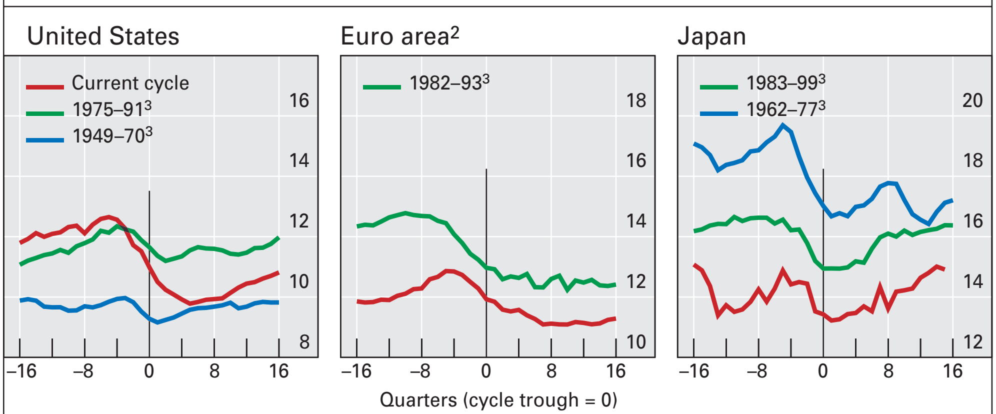
That nominal investment/GDP ratios are still low in most advanced economies remains a puzzle. Part of the explanation could be the fall in the relative price of business fixed investment. For instance, in Japan and the United States the relative price of capital goods has declined by between 25 and 40% since 1980. This would lead to lower nominal investment rates to the extent that the relative price effect is not offset by capital deepening.

Lower capital goods prices are one possible factor in low investment levels …

Changes in the structure of economic activity could be another factor behind lower measured investment. Intangible assets, such as brand values and business processes, apparently play a larger role in production now than in the previous decade. However, such investments might not be well captured statistically. In addition, the globalisation of production processes could have lowered investment rates in advanced economies. Indeed, foreign direct investment has been strong, especially in China, but it is not clear whether this is a substitute for investment in the home country. In the case of US multinational firms, vertical international integration seems to involve a combination of higher domestic and foreign investment instead of a simple relocation of domestic production.

… and changes in the production process are another

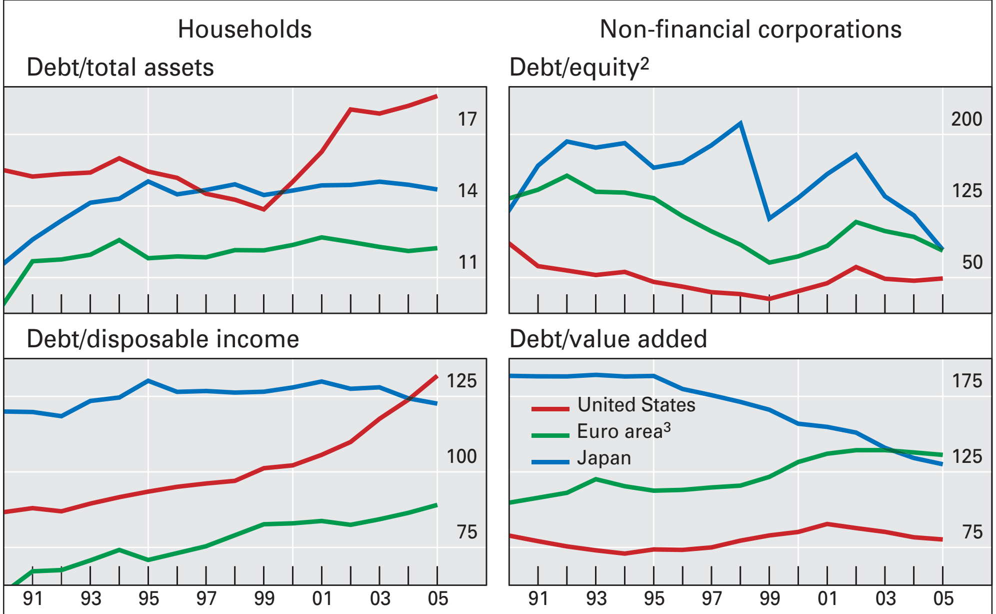
Corporate investment cycles[1]



[1] Based on investment/GDP ratios in nominal terms; in percentages. [2] Weighted average of France, Germany and Italy, based on 2000 GDP and PPP exchange rates. [3] Average of cycles with troughs between the dates shown.

Source: National data. Graph II.9

Private sector assets and debt[1]



[1] In per cent. [2] Equity defined as the market value of outstanding equities. [3] Weighted average of France, Germany and Italy, based on 2000 GDP and PPP exchange rates.

Sources: OECD; national data; BIS estimates. Graph II.10

Hurdle rates of investment may be relatively high in some sectors …

High hurdle rates of investment relative to expected returns may have deterred corporate management from expanding capacity in some sectors. One element behind this could be shareholder demands for high returns. Another possible factor is doubts about the sustainability of the boom in specific markets that are keeping expected returns on investment low. Indeed, investment in the oil industry seems to have been relatively weak globally, despite the sharp increase in profits in this sector in the past few years.

… and the memory of past overinvestment may still play a role

Related to this, it is not clear how quickly the legacy of past overinvestment is fading. On the one hand, investment in some IT sectors has rebounded in the past two years. More generally, the balance sheet deleveraging that occurred as a reaction to difficult financing conditions associated with the 2001 equity market collapse and the subsequent tightening of corporate governance seems to have run its course. Debt/equity ratios have fallen in the major advanced economies (Graph II.10). On the other hand, the global boom in leveraged buyouts in 2005 indicates a greater interest in buying existing fixed assets than in creating new ones.

Residential investment and housing markets

Residential investment was strong …

Notwithstanding somewhat slower growth in 2005, residential investment remained strong; its share of GDP was about 1½ percentage points higher than the long-term average of 5% in Australia and the United States. In Spain, residential investment as a share of GDP was about 9%, almost 3 percentage points higher than the average of the previous 10 years. Germany and Japan, in contrast, are notable exceptions to the picture of above average residential investment rates in advanced economies.

Construction sector in selected economies[1]

In per cent

	Strong activity period[2]					Change from peak to trough[5]	
	Date	Average growth rate[3]	Contribution to growth[4]	Peak share in nominal GDP	Peak share in employment	Real output	Employment
Germany	1988–94	3.1	9	6.3	8.5	–18	–20
Japan	1985–90	7.1	15	9.9	9.6	–21	–2
Spain	1994–2004	4.9	11	9.7	13.2	–20	–19
United States	1983–86	8.3	9	4.7	5.0	–13	–8
	1992–2000	2.6	3	4.4	5.2		

[1] National accounts definition (GDP by industry). [2] Continuous period of average annual growth of real value added in the construction sector of close to 3% or more. [3] Average annual change. [4] Contribution to growth of real GDP, as a percentage of GDP growth. [5] Change between the peak and the subsequent trough in construction activity; average for up to three major downturns since 1970.

Sources: OECD; national data. Table II.6

… and so was construction

Residential construction remained the main factor behind the most recent upswing in the US construction sector, which continued into early 2006. The Spanish construction sector is currently in its 13th consecutive year of expansion. This growth has been driven (as well as financed) to a considerable extent by external sources, mainly retiring baby boomers from northern Europe buying second homes on the Mediterranean coast.

Characteristics of earlier construction cycles

Over the past two decades, the construction sector (including residential and commercial construction) in the major industrial economies went through several cycles. Periods of strong activity tended to be fairly long, with upswings in the sample of countries shown in Table II.6 lasting from four to 10 years or more. During these periods, the construction sector easily contributed 10–15% to the overall growth of GDP, accounted for up to 10% of the total output of the economy at the peak of the cycle, and employed up to 13% of the total workforce. In the United States, for instance, the construction sector expanded on average by 8½% per year during the 1983–86 boom, contributing 9% to the growth of GDP during that period. The 1990s construction boom was less pronounced, although in terms of employment the sector's role increased somewhat. Construction booms also have positive effects on related industries such as real estate and leasing services. During 1983–86, for example, the share of these services grew by 0.7% of GDP in the United States.

Downturns in construction tended to be protracted …

Just as the upswings in the construction industry tended to be long, so the downswings were also often protracted and severe. In Germany, Japan, Spain and the United States, real output in the construction sector contracted by 13–21% during the major downturns of the past three decades, and sectoral employment declined by up to 20%.

… in particular in Germany and Japan

The most recent downturns in Germany and Japan were particularly severe. In Germany, sectoral output and employment both contracted by 30% between 1994 and 2004. Only in the course of 2005 were there tentative signs of a revival in building activity. Likewise, the construction industry in Japan has yet to recover after the bursting of the property bubble in 1990. Real output in the construction sector also declined by almost 30% between 1990 and 2003. Employment did increase slightly, however, as many construction workers were engaged in public sector projects that formed part of expansionary fiscal policies during the 1990s. Even so, the effects of the downturn on macroeconomic aggregates such as private consumption were clearly felt, as construction workers' wages were cut significantly.

Slower housing market activity should dampen consumption …

A slowdown in housing market activity and lower house price inflation would also imply less support for consumer expenditure through other channels. First, housing wealth grows more slowly (or even declines). Second, and related to this, the capacity to liquefy housing equity through borrowing against housing collateral diminishes. Australia, the Netherlands and the United Kingdom have experienced episodes of slowing house price inflation. In all three cases, this coincided with a substantial weakening of real consumption growth (Graph II.11).

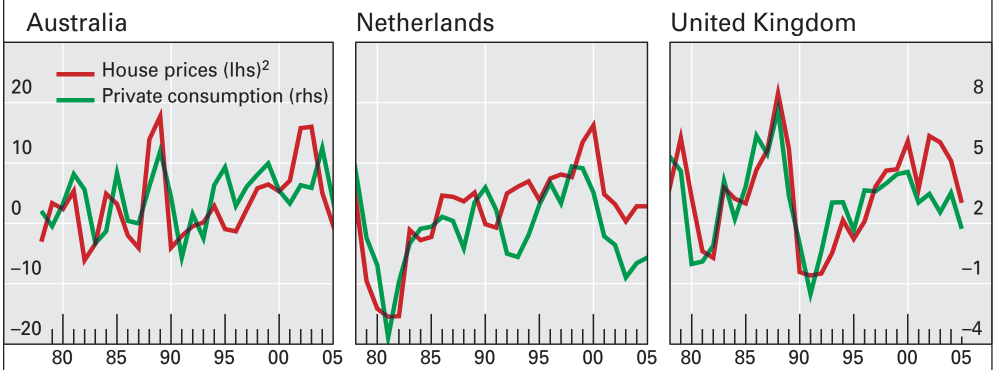
… although the effects of recent housing market slowdowns have been moderate to date

However, at least in Australia and the United Kingdom, the impact of slowing house price increases on consumption has been weaker than many had expected. Indeed, in both countries changes in real house prices in the first half of the current decade accounted for less of the fluctuation in real consumption than during the previous 25 years. One explanation might be that households, to some degree, anticipated a correction in sharply rising house prices. Another could be that, in the more recent environment of solid growth and low unemployment, households in Australia and the United Kingdom revised spending plans down to a lesser degree than, for instance, Dutch households during the economic downturn in 2001–03. Finally, while house prices levelled off in Australia and the United Kingdom, they did not fall significantly in real terms.

The impact of the housing market slowdown remains uncertain

The possible effect of slowing housing market activity on aggregate demand remains subject to considerable uncertainty. The current housing boom has been unusual in terms of its duration, size and the international co-movement of prices. House prices have risen sharply not only in many advanced, but also in many emerging economies, including China and Korea.

House prices and private consumption[1]



[1] Annual changes, in per cent; in real terms. [2] Deflated by the private consumption deflator.

Source: National data.

Graph II.11

Moreover, the current boom has coincided with a secular change in financing possibilities in many countries. On the supply side, a wider array of loan contracts has been offered to house owners. Consequently, borrowing against housing collateral has become cheaper and more readily available, which has allowed new categories of households to enter the housing market. In particular, sub-prime lending has increased significantly in countries where it is allowed. However, low interest rates have thus far kept the debt service burden in check, despite rising debt levels (Graph II.10).

Fiscal policy

Improvement in fiscal balances in 2005 …

Although the public finance outturns in 2005 were generally better than expected a year ago, fiscal deficits in many advanced economies remained high. Reflecting favourable cyclical developments, headline deficits were reduced by about 1% of GDP in the United States and Japan and by about ½ percentage point in the euro area (Table II.7). Structural budget deficits, which remove cyclical effects from headline deficit figures, also declined, but in many countries remained at levels that indicate the need for further fundamental fiscal adjustment.

… significant in the United States …

The improvement in the US headline fiscal position came as a result of strong revenue growth, with corporate income tax receipts increasing particularly sharply, and relatively tight controls on non-discretionary spending. The deficit is expected to remain more or less unchanged in 2006, reflecting less buoyant revenue growth as well as the costs of post-hurricane rebuilding and ongoing military operations overseas.

… and moderate in the euro area

In the euro area, modest real growth helped improve revenue ratios slightly, while expenditure ratios stayed broadly stable. Yet deficits remained

Recent fiscal performance and medium-term fiscal projections[1]

	Financial balance			Structural balance[2]			Gross public debt		Change in fiscal position over medium term[3]		
	2004	2005	2006	2004	2005	2006	2005	2006	Year	Financial balance	Gross public debt
United States	–4.7	–3.8	–3.6	–4.4	–3.7	–3.7	64	64	2009	1.3	0
Euro area	–2.8	–2.4	–2.3	–2.3	–1.6	–1.6	78	78	2008	1.1	3
Germany	–3.7	–3.3	–3.1	–2.7	–2.2	–2.1	70	71	2009	1.8	1
France	–3.7	–2.9	–2.9	–2.9	–2.0	–2.1	77	76	2009	2.0	3
Italy	–3.5	–4.3	–4.2	–3.4	–3.7	–3.6	121	122	2009	2.8	7
Spain	–0.2	1.1	1.1	0.3	1.3	1.3	50	48	2008	–0.4	7
Japan	–6.3	–5.2	–5.2	–5.6	–4.9	–5.3	172	175	2011	1.6	0
United Kingdom	–3.3	–3.2	–3.4	–3.6	–3.1	–3.1	47	50	2011	1.6	–3
Canada	0.7	1.7	2.2	0.6	1.7	2.1	69	63	2011	–1.1	26
Australia	1.3	1.5	0.9	1.2	1.5	1.0	14	13	2010	0.2	9[4]

[1] General government, as a percentage of GDP. [2] Cyclically adjusted financial balance, as a percentage of potential GDP. [3] Change, in percentage points, between the 2005 outcome and the year shown; national definitions. Positive numbers indicate a reduced deficit/increased surplus and reduced gross debt, respectively. [4] Net debt.

Sources: European Commission; IMF; OECD; national data. Table II.7

above the 3% reference value in four euro area countries (including Germany and Italy), while in France they were close to that threshold. Budget plans for 2006 imply basically no fiscal tightening in the euro area, in an environment in which economic activity is projected to accelerate towards potential.

Lower deficits but still high debt levels in Japan

In Japan, the headline deficit declined faster than expected, from over 8% of GDP in 2002–03 to slightly above 5% in 2005. The improvement reflected stronger than expected corporate and income tax revenues and some expenditure savings in the supplementary budget. In cyclically adjusted terms, the deficit dropped below 5% of GDP. However, a decade of high deficits has left Japan with gross public debt of over 170% of GDP, by far the highest among the major industrial economies. Net debt is substantially lower but, at around 85% of GDP, is still far higher than in most other advanced economies.

Prospects for fiscal consolidation remain uncertain

Beyond 2006, in many cases it remains uncertain whether there will be major progress towards fiscal consolidation. In the United States, the authorities have announced their intention to bring the federal deficit down to about 1½% of GDP by 2009, although specific policy changes to achieve this objective have yet to be confirmed. In the euro area, fiscal tightening is intended at only a measured pace. A key issue is how strictly the revised Stability and Growth Pact will be enforced. While views on this differ, most policymakers argue that the new rules have weakened the "corrective arm" of the pact (ie the excessive deficit procedure) and will provide for somewhat greater flexibility in the use of fiscal policy. Germany plans to reduce its deficit to below 3% of GDP in 2007, largely through a 3 percentage point increase in the VAT rate. In Japan, the authorities have decided to bring forward the target date for achieving primary balance by one year to fiscal year 2011. Again, however, specific policies to achieve this target have yet to be elaborated.

Challenges to fiscal sustainability

The persistence of large fiscal deficits …

The basic sustainability condition – that in the long run the stock of government debt should not grow faster than nominal GDP – has not been satisfied in the United States and the euro area since 2001, and in Japan since the late 1980s. In fact, in the most recent period of rapid expansion in the euro area, structural budget deficits increased (Graph II.12). In the United States, structural budget deficits declined during the latest period of strong growth (2002–05), but much less than in the 1990s expansion.

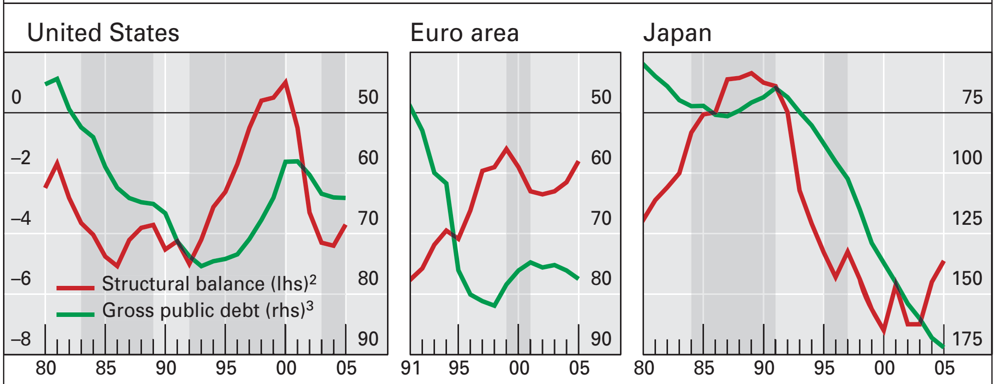
… has aggravated concerns about sustainability

The persistence of large budget deficits even in an environment of strong global growth and low interest rates has raised concerns about the long-term sustainability of public finances in the major industrial countries. These concerns are aggravated by looming budgetary pressures due to expenditures required to sustain an ageing population, and the associated prospect of lower potential growth.

Sustainability becomes more pressing as spending on pensions increases …

Population ageing will increasingly affect fiscal sustainability over the coming decades. Public spending on old-age pensions is forecast to rise in the countries shown in Table II.7, by almost 3% of GDP on average by 2050. However, the projected increase in pension spending varies considerably across countries;

Fiscal developments in different growth periods[1]



[1] General government. The shaded areas mark periods of strong economic growth. [2] Cyclically adjusted financial balance, as a percentage of potential GDP. [3] As a percentage of GDP; inverted scales.

Source: OECD. Graph II.12

relative to 2000, the ratio of old-age pensions to GDP would decrease in Italy and the United Kingdom, but would go up by 8 percentage points in Spain.

... and health care costs rise

Public spending on health and long-term care looks set to increase massively. OECD projections suggest that, in the absence of policy action, public spending on these items in the major industrial countries shown in Table II.7 could surge from an average 7% of GDP in 2005 to 13% in 2050. Moreover, in contrast to pensions, the predicted rise in health and long-term care spending is fairly uniform across countries. Even in a scenario that embodies the assumed effects of policies to curb the growth of these expenditures, average spending on health and long-term care would still go up by 3½ percentage points, to reach 10½% of GDP on average by 2050.

Slower growth poses additional risks ...

These projections all assume relatively favourable macroeconomic conditions. Slower than expected growth of national income would quicken the pace of deterioration in underlying fiscal positions. The euro area and Japan would also have to expect a significant fall in the average potential GDP growth rate, if the effect of population ageing is not offset by later retirement and accelerated productivity growth. This in turn underscores the need for structural reforms. The United States may be in a more favourable position in this respect. It is expected to be less affected by the slowdown in population growth and has exhibited consistently stronger productivity growth over the past decade.

... as do higher interest rates

The seriousness of the public debt problem has to some degree been masked by the low level of long-term interest rates. Government net interest payments declined by 0.6 percentage points of GDP between 2000 and 2005 in the United States, and by 0.8 percentage points in the euro area. In Japan, debt servicing costs fell by 0.2 percentage points of GDP over this period, despite a massive increase in public debt. A sharper than expected rise in long-term interest rates would thus complicate the choices that fiscal policymakers must make to set public finances on a sustainable path. In this regard, the United States is in a less favourable position than other countries because of the low national saving rate.

Current account developments

External imbalances widen further

Further sharp increase in the US current account deficit

Global current account imbalances continued to widen in 2005. The external payment deficit of the United States reached $800 billion in 2005, or 6½% of GDP, an increase of almost $140 billion within one year (Table II.8). While the euro area recorded broadly neutral external payments, the current account positions of individual member countries widened sharply: Germany's surplus rose to more than $110 billion (4% of GDP) at the same time as Spain's deficit jumped to almost $85 billion (7½% of GDP). The Japanese surplus remained large, at about $170 billion or 3½% of GDP. Several smaller European economies, such as Norway and Switzerland, also ran large surpluses.

Rising energy bills accentuated deficits in advanced economies

Higher energy prices were again a key factor explaining widening external imbalances in 2005. The oil trade balance of advanced oil-importing countries deteriorated in the order of 1½% of their GDP. In the case of the United States, net energy imports increased by $70 billion last year, almost the same amount as the total increase in merchandise exports; energy now accounts for one third of the US trade deficit.

Changing composition of surpluses

Higher energy prices also led to a major shift in the composition of external surpluses. The collective surplus of oil-exporting countries grew to about $420 billion in 2005, compared to less than $90 billion in 2002 before oil

Global current account balances

In billions of US dollars

	Average 1991–2001	2002	2003	2004	2005	*Memo: 2005*[1]
United States	–178	–475	–520	–668	–805	*–6.4*
Euro area[2]	13	39	32	74	–16	*–0.2*
Germany	–21	41	46	102	115	*4.1*
Spain	–12	–23	–32	–55	–83	*–7.4*
Japan	105	112	137	171	168	*3.7*
Other advanced industrial economies	–3	34	55	48	44	*0.8*
China	14	35	46	69	161	*7.2*
Other emerging Asia	15	92	120	115	82	*2.6*
Latin America	–49	–16	7	18	30	*1.2*
Central and eastern Europe	–13	–24	–37	–59	–65	*–5.4*
Oil-exporting economies	5	87	143	239	417	*9.6*
Norway	9	24	29	35	49	*16.7*
Russia	12	29	35	59	84	*11.0*
Saudi Arabia	–6	12	28	52	91	*29.5*
Oil-importing economies	–101	–239	–210	–304	–515	*–1.3*
Advanced	–67	–328	–338	–431	–683	*–2.2*
Emerging	–34	89	128	127	168	*1.8*

[1] As a percentage of GDP. [2] Sum of the balance of individual euro area economies.

Sources: IMF; national data. Table II.8

prices had started to rise. High oil prices had an even stronger impact on oil-importing emerging economies, which typically have a higher oil intensity of output. For instance, China's oil trade balance deteriorated by 4% of GDP between 2002 and 2005. Even so, the aggregate current account surplus of oil-importing emerging economies continued to expand, reaching $170 billion in 2005, compared with about $90 billion in 2002. China's external payments surplus jumped to $160 billion (7% of GDP) on the back of unabated export growth and a marked slowdown in import growth. Latin America as a whole also recorded a growing surplus as a number of countries benefited from both rising commodity prices and a higher volume of exports (see Chapter III).

Global rebalancing and oil revenue recycling

Traditional adjustment forces were muted ...

The traditional forces that might favour external adjustment provided little support to, or even worked against, global rebalancing in the period under review. The US dollar appreciated by 4% in real effective terms in the course of 2005 while the yen depreciated (see Chapter V). Emerging Asian currencies appreciated moderately, but insufficiently to trigger a substantial change in trade flows. Appreciating real effective exchange rates contributed to persistently high external deficits in Australia (6% of GDP) and New Zealand (9% of GDP). The growth differential between the United States and other major advanced economies, though narrowing in the course of the year, remained significant and supportive of the dollar. Finally, low long-term real interest rates continued to underpin strong household demand growth (including residential investment) in the United States and elsewhere.

... and high oil prices might further delay external adjustment

In addition, external adjustment to the current oil price shock might take longer than in the late 1970s. At that time, the large current account surpluses of oil exporters were reversed within a few years. Fearful of rising inflation and inflation expectations, monetary authorities tightened policy sharply. This led to a recession in oil-importing economies, and in turn to a collapse in oil demand. This time, however, contained overall inflation has allowed the monetary response to be much more moderate. Accordingly, global growth and oil demand have remained strong.

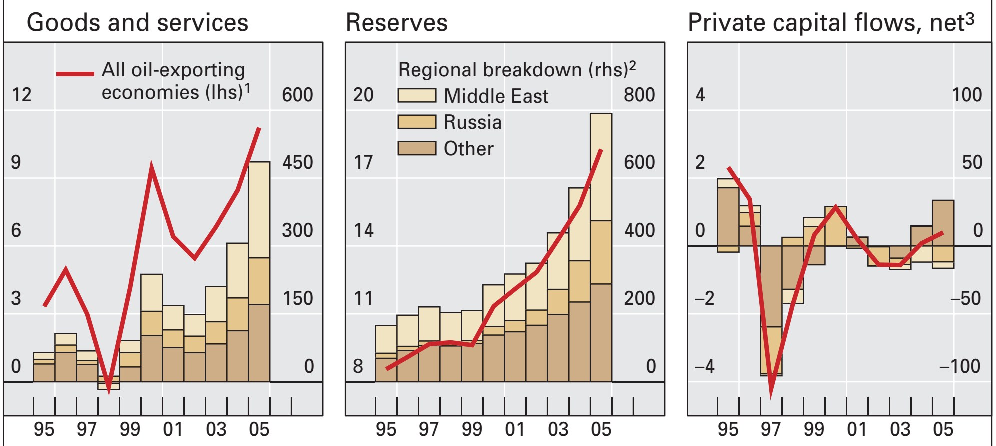
A lower propensity to spend oil revenues on imports ...

Oil-exporting countries apparently spent a smaller proportion of oil revenues on imports in 2005 than in the previous two years, and less than at the time of the previous oil shocks. In 2005, the trade surplus of oil exporters jumped to more than $450 billion, equivalent to more than half of total oil revenues (Graph II.13). The primarily oil-exporting emerging economies, which accounted for the lion's share of this increase, spent only about half of the rise in oil receipts on additional imports of goods and services. The comparable figure in 2003 and 2004, and on average during the previous oil shocks, had been about three quarters. Identifying and exploiting domestic investment opportunities in oil-exporting countries may take time – in fact, more time than effecting a real transfer of resources primarily through higher consumption expenditures, as was the case in the 1970s.

... increases the importance of investments

The way in which oil-exporting countries spend their receipts could also have an impact on the effectiveness of external adjustment mechanisms. European countries have probably been main beneficiaries of additional

Balance of payments indicators of oil-exporting economies



[1] As a percentage of GDP. [2] In billions of US dollars. [3] A positive value indicates a net outflow.

Source: IMF. Graph II.13

demand for imports in oil-exporting countries since 2003. China has also succeeded in increasing its export share, while the United States has suffered a significant loss. However, the limited data available suggest that much of the increased surpluses of oil exporters continues to be invested in US securities, although there has been a significant diversification across asset classes. These now include a larger proportion of corporate and agency bonds as well as equities (see Chapter VI). Notwithstanding greater diversification, the growing size of oil exporters' investments might still have provided support to the dollar and helped to keep US long-term interest rates low.